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January 13, 1995

BY HAND DELIVERY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. - Room 222
Washington, D.C. 20554

Re: MM Docket Nos. 92-266, 93-215
Seventh Notice of Proposed Rulemaking

Dear Mr. Caton:

A&E Television Networks, Inc., by its attorneys and pursuant to Section 1.419 of the Commission's Rules, hereby submits an original and nine copies of its Comments filed in response to the Commission's *Seventh Notice of Proposed Rulemaking* in the above-captioned proceeding. An additional copy is included to be stamped as a receipt copy.

Please contact the undersigned if you have any questions with regard to this matter.

Respectfully submitted,

HOGAN & HARTSON L.L.P.

By: Robert Corn-Revere
Robert Corn-Revere

Attorneys for The A&E Television Networks, Inc.

Enclosures

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Before the

FEDERAL COMMUNICATIONS COMMISSION

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In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket Nos. 92-266, 93-215
Protection and Competition	)	
Act of 1992: Rate Regulation	)	

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COMMENTS OF A&E TELEVISION NETWORKS, INC.

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January 13, 1995

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SUMMARY

A&E Television Networks, Inc. ("A&E") is an independent cable programmer that delivers both A&E, a well established channel distributed to more than 59 million cable households, and The History Channel, a newly-launched service. As the provider of both established and brand-new cable programming services, A&E has a substantial interest in the adoption of cable rate regulations which recognize the diversity among cable networks and maximize the availability of programming to the public. Thus, A&E urges the Commission to retain -- if not increase -- the 7.5% mark-up on external costs for increases in programming costs.

The Commission's tentative conclusion that a mark-up on external costs is unnecessary is unsupported by Commission analysis. Indeed, there is no indication that the Commission even considered the sufficiency of compensation over time as licensing fees increase. Furthermore, the Commission's tentative conclusion reflects confusion concerning the distinction between the mark-up on external costs and the mark-up on new programming costs. The Commission's confusion is evident from its description of the comments it received on the going forward rules adopted in its *Second Order on Reconsideration*. In a description of the problems with a 7.5% mark-up on *new* programming costs, the Commission noted that, in letters to the Commission, some programmers favored retention of the 7.5% mark-up. In fact, none of the letters referred to by the Commission supported the retention of a 7.5% mark-up on new programming costs. These letters instead urged the Commission to retain or increase the 7.5% mark-up on

external costs. The Commission appears to have taken inadequate notice of these arguments when reaching its tentative conclusion that the mark-up on external costs is unnecessary.

Contrary to the Commission's tentative conclusion, elimination or reduction of the mark-up on external costs would cause cable operators' profit margins to decline precipitously over time. Indeed, even a 7.5% mark-up would cause a progressive reduction in cable operators' profit margins and eventually could be insufficient to warrant investments by cable operators in programming services as the price of these services increases. This decline in profits would in turn encourage cable operators to replace established programming services with new programming services based upon the preservation of profit margins, rather than sound editorial judgment. Even if this phenomenon is not wide-spread, the effect could be devastating for established cable programming services.

A meaningful mark-up on external costs for increases in programming costs is an important aspect of the Commission's efforts to increase the cable programming available to the public. Thus, A&E respectfully urges the Commission to retain or increase the 7.5% mark-up on external costs.

Before the

FEDERAL COMMUNICATIONS COMMISSION

Washington, D.C.

In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket Nos. 92-266, 93-215
Protection and Competition	)	
Act of 1992: Rate Regulation	)	

To: The Commission

COMMENTS OF THE A&E TELEVISION NETWORKS

The A&E Television Networks, Inc. ("A&E"), by its attorneys and pursuant to Section 1.415 of the Commission's rules, hereby submits these Comments in response to the Commission's proposals in its *Sixth Order on Reconsideration, Fifth Report and Order, and Seventh Notice of Proposed Rulemaking*, FCC 94-286 (rel. Nov. 18, 1994) (the "*Seventh NPRM*"). A&E urges the Commission to retain -- if not increase -- the 7.5% mark-up on external costs for increases in programming costs. As shown below, a mark-up on external costs is necessary to maintain the value of cable operators' investments over time and to encourage investment in new original programming.

A&E Television Networks, Inc. is a cable programmer that is neither owned nor controlled by any cable operator. It offers both A&E, a well established channel, and a newly-launched service, The History Channel. A&E is currently delivered to more than 59 million cable households throughout the country via cable, TVRO, MMDS and SMATV distribution systems. It features critically acclaimed original entertainment programming, including the series BIOGRAPHY®, mysteries, dramatic programs and specials. Over 80 percent of the A&E Network's prime time schedule consists of original productions. The high quality, original programming offered on this network has earned A&E more CableAce Awards than any other basic cable network.

Given the success of the A&E Network and the extraordinary interest expressed by television viewers for a network devoted to historical subjects, 1/ A&E launched The History Channel on January 1, 1995. The History Channel is a unique, high-quality programming service featuring historical documentaries, movies and miniseries placed in historical perspective. Like A&E, the programming on The History Channel is designed to be supported substantially by advertisers and is consequently available to distributors at a low cost.

As a provider of both established and brand-new cable programming services, A&E has a substantial interest in the adoption of cable rate regulations which recognize the diversity among cable networks and ensure the maximum availability of programming to the public. Therefore, A&E advocated the adoption of rules which provide cable operators with incentives to add new high quality

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1/ Out of the non-cable subscribers who are most likely to subscribe to cable, the highest number (47 percent) indicated an interest in The History Channel, according to an independent 1994 Beta Research Cable Non-Subscriber Study.

programming services to their systems, while continuing to offer established programming services of proven value to subscribers.

I. BACKGROUND

A. The Going Forward Proceeding

A&E recently urged the Commission to promote new programming services in comments A&E filed in response to the Commission's *Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking,* FCC 94-40, MM Docket Nos. 92-266, 92-262 (rel. Mar. 30, 1994) (the "*Second Order on Reconsideration*"). In the *Second Order on Reconsideration*, the Commission had established a "going forward" methodology for rate adjustments resulting from changes in the number of channels on a regulated tier. Pursuant to this methodology, cable operators would be permitted to add a 7.5% mark-up to the actual costs of new programming added to a tier. *Id.* at ¶ 246. But the "mark-up" methodology was adopted for more than one purpose. Cable operators were also permitted to take a 7.5 percent mark-up on external costs for any increases in programming expenses incurred for programming already carried on their systems. *Id.* at ¶ 248. Decreases in programming expenses, on the other hand, would require a corresponding 7.5% mark-down. *Id.* at ¶ 246.

There was widespread concern that the incentives created for new programming were inadequate and that the Commission needed to revise its rules. The Commission ultimately agreed with the points made by A&E and many others that the 7.5% mark-up on new programming costs adopted in the *Second Order on Reconsideration* failed to provide operators with a realistic incentive to add new programming services to their systems. While the bulk of the comments focused on new programming incentives, A&E's comments also addressed the 7.5% mark-up on external costs for existing channel services. In that regard, A&E proposed an increase in the mark-up on external costs to 15%. 2/

As A&E pointed out, the mark-up on external costs serves a different purpose from the mark-up on the costs of new channels. It provides cable operators with an incentive to continue carrying established cable channels by ensuring that the operators' profit margin on these services is not reduced over time. The comments explained that a 7.5% mark-up on external costs does not even cover the cost of borrowing money to invest in programming and that an increase in the mark-up on external costs would prevent the erosion of cable operators' profit margins over time. An adequate mark-up, on the other hand, helps ensure the continued carriage of services of proven value to subscribers.

B. Limitations on External Cost Mark-ups

In its *Seventh NPRM*, the Commission enhanced the incentives in its cable rate regulations for the addition of new programming services to cable systems. While maintaining the existing going-forward methodology, the Commission also created an alternative channel adjustment methodology. Under

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2/ *See also* Comments of Cox Cable Communications, Inc. and Newhouse Broadcasting Co., "Adding Channels: A Proposed Approach for Restoring Incentives to Carry New Programming Services," May 31, 1994, at 18.

the new rules, which became effective on January 1, 1995, cable operators which add new channel services after May 15, 1994, may apply the 7.5% mark-up for newly-added channels established in the *Second Order on Reconsideration*, or they may apply a flat per-channel mark-up. 3/

At the same time, however, the Commission restricted the ability of operators to mark-up by 7.5% programming price increases passed through as external costs. First, the new rules eliminated any external cost mark-up on channels for which the operator elected to take a 20-cent flat fee. The Commission explained that "our analysis indicates that the 20 cent per channel adjustment will provide full and fair compensation to operators adding new channels to CPSTs." 4/ Additionally, the Commission asked for comment on whether to retain the 7.5% mark-up for programming cost price increases for existing channels. 5/ The *Seventh NPRM* explained that the purpose of the programming incentives is "to compensate

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3/ The Commission established a flat mark-up rate of 20 cents per new channel, with an additional mark-up for license fees, subject to a total price cap. Once a cable operator chooses between the 7.5% mark-up and the flat mark-up rate, it must apply the chosen mark-up for all rate adjustments for that channel. *See Seventh NPRM* at ¶¶ 64-86. However, a cable operator may choose to apply the flat mark-up rate after January 1, 1995, but still apply the 7.5% mark-up for channels added between May 15, 1994, and December 31, 1994. *Id.* at ¶ 65 n.21*.

4/ *Id.* At ¶ 132. There is no explanation in the *Seventh NPRM* as to how the compensation for channel additions related to the compensation for programming price increases over time. The *Seventh NPRM* summarily states at two places that the flat fee will provide "full and fair" compensation but does not provide the basis for this conclusion as it relates to external cost increases. *Id. See also id.* at ¶ 83 (quoting identical language).

5/ *Id.* at ¶ 134.

for added costs outside the operators' control and not to provide an additional mark-up without a clear policy purpose." It added that "there appears to be no strong reason to allow a mark-up on programming cost increases for a service already being offered." [6] The Commission tentatively concluded that the 7.5% mark-up on external costs for existing channels is unnecessary. [7]

II. THE COMMISSION MUST RECONSIDER ITS CONCLUSIONS REGARDING EXTERNAL COST MARK-UPS

A. The Initial Conclusions Are Not Based on Record Evidence or Analysis

The Commission must reconsider its conclusion that a mark-up on external costs is unnecessary. Neither the *Seventh NPRM* nor the attached Technical Appendix provides the slightest indication that the Commission actually considered the economic implications of its decision and tentative conclusions. Quite to the contrary, the decision suggests that the Commission misinterpreted comments filed by A&E and others on the external cost issue. For that reason, the *Seventh NPRM* does not address the concerns expressed in the Going Forward proceeding regarding external costs.

The Commission's *Seventh NPRM* provided no explanation for its conclusions regarding external costs but simply stated that "we have determined"

6/ *Id.*

7/ *Id.* at ¶ 133.

that the mark-up is unnecessary. However, there is no indication that the Commission even considered the sufficiency of compensation for programming price increases over time. Rather, the entire Technical Appendix was devoted to discussing the appropriate compensation for new channels. Indeed, the Commission's methodology was predicated on examining the price per channel when new channels are added. 8/ For example, in establishing the "license fee reserve," which is intended to compensate operators for programming costs associated with channel additions, the Commission expressly selected a number that "excluded license fee increases associated with channels already on some cable systems." 9/ There is no evidence that the Commission considered at all the sufficiency of compensation over time as licensing fees increase.

Additionally, the Commission's tentative conclusion that a mark-up on external costs is unnecessary reflects confusion concerning the distinction between the mark-up on *external costs* for existing channels and the mark-up on *new programming* costs. The Commission's confusion is evident in its description of the comments it received on the going-forward rules adopted in its *Second Order on Reconsideration*. In this description, the Commission explained the problems with

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8/ *See id.*, Appendix C at pp. 10-17.

9/ *Id.* at 21. The Commission selected a 5-cent per channel estimate of the appropriate level of compensation for license fees, an amount that was calculated based on average amounts for new channels in their first year of carriage. The estimate of the average license fee for more mature channels was 12.9 cents per subscriber. The Commission's choice for the license fee reserve, to the extent it even applies to external costs, indicates that the Commission did not consider the need for fee increases as a component of compensation over time.

the 7.5% mark-up on *new* programming costs, as identified by petitioners and commenters. However, the Commission also stated that "[s]ome programmers, however, favor retention of the 7.5% mark-up." 10/ In support of this statement, the Commission cites letter submitted by Black Entertainment Television, Discovery Communications, Inc., A&E, and Lifetime Television.

In fact, none of these programmers were writing to advocate retention of the 7.5% mark-up on new programming services in these letters. To the contrary, these letters urged the Commission to retain or increase the 7.5% mark-up on *external costs* because they had heard that the Commission was considering elimination of this mark-up. The Commission appears to have taken inadequate notice of these arguments when reaching its initial conclusion that the mark-up on external costs is no longer necessary. As A&E told the Commission:

> The Commission should take care that its going forward methodology does not create an incentive to add or delete programming services based on the rules' economics rather than sound editorial practices. If the amount of the mark-up allowed for cost increases of existing services leads to a declining margin over time, operators will have an incentive to drop existing services for no other reason than to preserve existing margins. 11/

Consequently, A&E advocated increasing the external cost mark-up to 15%. 12/

10/ *Id.* at ¶ 59.

11/ Letter from Nickolas Davatzes to Hon. Reed Hundt, Oct. 12, 1994.

12/ *Id.*

B. The Mark-up on External Costs is Vital to Preserve Quality Programming Services

A&E again urges the Commission to retain, if not increase, the 7.5% mark-up on external costs for increases in the programming costs of channels carried since before May 15, 1994. If the Commission eliminates the mark-up on external costs, cable operators' profit margins would decline precipitously over time. Even a 7.5% mark-up would cause a progressive reduction in cable operators' profit margins and eventually could be insufficient to warrant investments by cable operators in programming services as the price of these services increases. [13] The downward effect on operators' profit margins would be much stronger if the mark-up were eliminated altogether.

Cable operators will naturally seek ways to restore these profit margins. The imbalance created by the current rules will lead operators to make programming decisions based on the preservation of margins, and not on sound editorial judgment. This could lead operators to revamp program offerings in response to the rules. Even if this phenomenon is not wide-spread, the effect could be devastating for established cable programming services. For example, Paul Kagan Associates has estimated that a 10 percent drop in penetration for an established cable programming service would lead to a reduction in cash flow by two-thirds, while a 25 percent drop in audience reach "could theoretically wipe out

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13/ *See, e.g.,* Comments of A&E and ESPN at 13; Comments of Cox Cable Communications, Inc. and Newhouse Broadcasting Co., "Adding Channels: A Proposed Approach for Restoring Incentives to Carry New Programming Services" (May 31, 1994), at 18.

cash flow." 14/ Because "[t]he average network spends virtually 100% [of] network ad revenue on programming . . . especially [on] costly original productions," even a small reduction in penetration would force an established cable programmer to reduce spending on the production of new programming. According to the Kagan study, the result would be "a damaging chain reaction" that "could negatively affect program budgets, resulting in homogenization of cable programming and fewer choices for the cable consumer." 15/

CONCLUSION

A mark-up on external costs for increases in programming costs is an important component of the Commission's efforts to increase the cable programming available to subscribers. A&E respectfully urges the Commission to reject proposals

14/ Paul Kagan Associates, Inc., Cable TV Programming (March 23, 1993), at 1-2.

15/ *Id. See also* Hazlett, Regulating Cable Television Rates: An Economic Analysis (July 1994).

to eliminate or reduce the 7.5% mark-up on external costs. If the mark-up on external costs is changed at all, it should be increased.

Respectfully submitted,

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